The difference between funds with discounts or premiums is more than pricing

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed John Cole Scott, chief investment officer at Closed-End Fund Advisors and the chairman of the Active Investment Company Alliance. Read the Q&A below as John discusses some equity and fixed-income funds currently trading at premiums and compares them with similar funds priced at a discount, noting that expenses, payouts, and more determine relative values. Further, he notes that when the market takes a dive and discounts widen, investors should consider whether the best bargain is the fund with the widest discount or the fund whose premium has evaporated.

John Cole Scott

The podcast can be found on AICA's website by clicking here: https://aicalliance.org/alliance-content/pod-cast/

CHUCK JAFFE: John Cole Scott of Closed-End Fund Advisors is here, and we're talking about some closed-end funds trading at a premium, some others trading at a discount, and everything in between, welcome to The NAVigator. This is The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator's brought to you by the Active Investment Company Alliance, a unique industry organization that represents all facets of the closed-end fund industry. From users and investors to fund sponsors and creators, if you're looking for excellence beyond indexing, The NAVigator's going to point you in the right direction. And

today it points us back in the direction of John Cole Scott, the chief investment officer at Closed-End Fund Advisors in Richmond, Virginia, which is online at CEFAdvisors.com. We're going to dig into funds using the firm's research, which you can dig into yourself at CEFData.com. John is also chairman of the Active Investment Company Alliance, which you can learn about at AICAlliance.org. John Cole Scott, it's great to chat with you again.

JOHN COLE SCOTT: Always good to be here.

CHUCK JAFFE: John, we've talked plenty of times about the importance of discounts in closed-end funds, and most people when they see a fund trading at a premium, they're kind of turned off by it. It's as if a premium is a terrible thing. But it's not necessarily a bad thing, and you have some research looking at funds that are trading at premiums and how they really compare to some of their peers that are priced more much cheaply. Dig into it for us.

JOHN COLE SCOTT: Sure, so we've really come across this concept in the last 20 years of my career. There are some funds that typically and historically trade above average to their peer group, and even to what would be logical by many outside bystanders accounts. And we looked at really four of these, two equity, two bonds, and I'll kind of break them in those two buckets. For the equity funds we looked at Gabelli Equity Trust, that's GAB, and the Eaton Vance Tax-Managed Buy-Write Opportunity Fund, that's ETV. Currently they're trading at a 17% and 13% premium over net asset value. And when I dug into it, the best answer I have is that they have rather reasonable expense ratios and they really haven't made a dividend change, even to the upside in forever, over eight years for these funds, but really to the downside. One of the I'd say interesting things is these funds currently are showing yields of eight and high change and 10 and low change, but when you really think about an equity exposure to closed-end funds, you're basically tapping into expected long-term net asset value performance, and it's being given to you either monthly or quarterly by these products that have been designed to really aid investors in their retirement savings. And so I just really feel like it can be challenging to have such a high premium when you really just have to ride the rails of equity markets.

CHUCK JAFFE: We know that plenty of people dislike premiums, but can I get the same things and get it on sale? Just because a fund has a good discount or a reasonable discount doesn't make it a good proxy for those kinds of high yielding funds.

JOHN COLE SCOTT: Yes, so what we did, we looked at funds that have each been around for a while. For these equity funds there's AOD, it's a global dividend fund run by Abrdn, and then there's FFA, it's a First Trust covered-call fund. They're basically, one's at 11 and high change discount, one's at almost a 3% discount, so again, not a big, fat discount but the whole sector's trading well. I think the major difference is they're yielding eight and low change versus seven and low change, you're not getting as much indicated yield. The expense ratios are a little higher, which again we always love lower expense ratios, but sometimes with active management you also get what you pay for and no investments are ever the same. But the three-year net asset value performance on average for these two funds is around 30% for the discounted funds, and it's only 25% for the premium funds. So you would like to think, and remember these aren't perfect proxies, that if you're really trading much better it's because you're performing much better. And so the challenge is that these funds probably will keep these premiums until they make a dividend change, and if we do this podcast 10 years from now they may not have changed their dividends until then. But they always could, and that to me is the risk factor to try and avoid, especially for equity funds.

CHUCK JAFFE: And do you have the same setup in bond funds? Is it the same across asset types?

JOHN COLE SCOTT: A little bit. So the funds we looked at here, one is a PIMCO Corporate Income Strategy Fund, PCN, again at an 18% premium, and Guggenheim Strategic Opportunity Fund at a 25% premium, which is again pretty high up there. They're each sporting yields that average around 11%, which is a relatively high number, and the managers have to clear over 10% to fuel that policy. They also have a long-term history of no changes. In this case we looked less at their NAV performance because dividends coming from bond funds are much more tied to their portfolios, but we found similar funds at discounts that had a similar make up of investment grade, non-investment grade, unrated, durations that were around the same and maturities that were pretty close. So not the same thing but relatively different. Those discounted funds that we were looking at, one is the Angel Oak Strategic Income Term Trust Fund, FINS, it potentially just benefited from its merger with its sister fund, DYNS, which will make it a larger fund, hopefully gaining more interest from investors being at a more liquid trade volume. And then a relatively new fund, WDI, and these funds on average are a 9% discount, a 9.5% yield, which again is lower, but

the average closed-end fund yields 9%, so these are not outside the makeup of normal levels. I would say this, people often seem reluctant to buy newer funds. These funds, one's three years old, one's about eight months old. They often love the fund that has a dividend history that looks like it's bulletproof. And I guess the concept I really want to remind people is that if you were to take these two baskets at a high level and you get a 9% discount versus a 16% average premium, the discount one is yielding just under 9%, the premium basket's yielding just under 11%. But the challenge is, the dividends that come out of the discounted funds often can be considered as cheap tenders when there's a discount. Premium funds are just really challenging because it's hard to want to buy more because you're paying too much for it. Now maybe you bought it at par or bought it at discount and you're a very happy investor, but I think the one thing I always seem to come across is people that they expect the past to always be the past and the future. Who knows the next three weeks versus three years for capital markets? Right, Chuck? Unexpected should be the outcome versus the same path forward from the last 10 years.

CHUCK JAFFE: It's interesting to me because so many folks are looking at discounts, and they look at that as the big tie breaker without necessarily looking at expenses. But from your research, what I'm learning is if you've got a big discount but you also have a big expense ratio, you're not as much of a bargain when I look at the other numbers.

JOHN COLE SCOTT: Absolutely, expense ratios are probably third on our list. But I would tell, when there's an equity fund as a basket of listed things that I could buy on my own if I felt like doing it, I don't see why you justify an above average. Credit funds where there's active hedging and swapping or active managers, all four of these bond fund managers are excellent bond fund managers, so it's not saying that they're not worth a good expense ratio. And I would just say that expense ratios is important, but again, I would say that I would be thoughtful on just sorting by expense ratios. You will find funds that are 10 to 20 years older historically have a lower on average fee than funds that are five years are younger just based on changes that we've noticed in the closed-end fund marketplace.

CHUCK JAFFE: Is the other moral of this story that although we shouldn't necessarily dive in and go, "Premium? Wow! It just means everybody's so excited about this," but premiums shouldn't be quite the big turnoff that they historically have been?

JOHN COLE SCOTT: The next time we have a real shakeout, I mean worse than June 16th of this year, when these premium funds come down to either a small premium or a small discount, is a time to maybe put a bet in these funds because they've historically shown they can trade well and investors even recovering from Covid and other pullbacks in the market can be a good entry point in premium funds when they go to small premiums or tiny discounts. Even better trade than going from that 10% discount down to a 17% in the market.

CHUCK JAFFE: It's really interesting. I want to make sure we didn't miss one ticker symbol, the Guggenheim fund that you were talking about back when you were talking about the bond funds that were trading at a premium.

JOHN COLE SCOTT: I'm sorry, GOF.

CHUCK JAFFE: GOF. So we've got all of those, but if you want more information, and you want to get it from John, well, he's prepping some work on this. So if you're looking for more information in the research, it's not just going to CEFData, you can send him a note. Send it to TheNAVigator@AICAlliance.org and John will follow up on the research as it continues to move forward and send it off to you. Meanwhile, John, we've benefited from the research, thanks so much for joining me.

JOHN COLE SCOTT: Enjoyed it so much, Chuck.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And yes, that's me, and you can learn all about my work and my show at MoneyLifeShow.com. To learn more about closed-end funds, business-development companies, and interval funds generally go to AICAlliance.org, the website for the Active Investment Company Alliance. They're on Facebook and LinkedIn @AICAlliance. And if you have questions about closed-end funds, send them to TheNAVigator@AICAlliance.org. Thanks to my guest John Cole Scott, chief investment officer at Closed-End Fund Advisors in Richmond, Virginia, the chairman of the Active Investment Company Alliance. His firm is online at CEFAdvisors.com and CEFData.com, and he's on Twitter @JohnColeScott. The NAVigator podcast is available every Friday, please subscribe on your favorite podcast app and join us again next week. Until then, happy investing everybody.

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